DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

Attn:

FROM: DEBORAH A. BUTLER
ASSISTANT CHIEF COUNSEL (FIELD SERVICE)
CC:DOM:FS

SUBJECT: Exchange gain in section 304 transaction; determination of earnings and profits

This Field Service Advice responds to your memorandum dated September 14, 1998. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

Parent =

Sub1 =

Fsub1 =

Fsub2 =

Country X =

Region1 =

[redacted]

State Y	=
TY1	=
TY2	=
YearA	=
YearB	=
YearC	=
YearD	=
Date1	=
Date2	=
Date3	=
Date4	=
Date5	=
Date6	=
$aa	=
$bb	=
$cc	=
$dd	=
$ee	=
$ff	=
$gg	=
$hh	=
$ii	=
$jj	=
$kk	=
$ll	=
$mm	=

[redacted]

$nn	=
$oo	=
$pp	=
$qq	=
$rr	=
$ss	=
$tt	=
$uu	=
$vv	=
$ww	=
$xx	=
$yy	=
$zz	=
$aaa	=
$bbb	=
$ccc	=
$ddd	=
$eee	=
$fff	=
$ggg	=
$hhh	=
ƒaaa	=
ƒbbb	=
ƒccc	=
ƒddd	=
ƒeee	=

[redacted]

Court A	=	
Case#	=	
r%	=	
s%	=	
t%	=	

ISSUES:

1. Whether, for purposes of calculating the gain recognized in a transaction under I.R.C. § 304(a)(1) in TY1, Sub1 should increase its basis in the stock of Fsub1 by the amount of an exchange gain recognized under I.R.C. § 986(c)(1) with respect to the deemed distribution of previously taxed income ("PTI") under I.R.C. § 959.

2. Whether Fsub2's distribution to Sub1 in TY2 constituted a dividend rather than a return of capital.

CONCLUSIONS:

1. The exchange gain should not increase the basis of the acquiring corporation's stock for purposes of calculating capital gain on the section 304 transaction.

2. Any portion of the distribution in TY1 from Fsub1 to Fsub2 that was properly treated as a return of capital would not increase the E&P of Fsub2. [redacted]

ISSUE 1. CAPITAL GAIN ON § 304 TRANSACTION

FACTS:

A. Sub1's Sale of Fsub1 to Fsub2

Parent is a domestic corporation which was the common parent of an affiliated group that filed consolidated income tax returns for TY1 and TY2.

During YearB, Parent formed Fsub1, a Country X corporation, with a contribution of cash. On Date1, Parent transferred the stock it held in certain Country X corporations to

[redacted]

Fsub1 in exchange for voting common stock and profit participation rights, which Parent characterizes for U.S. tax purposes as nonvoting preferred stock. During the YearB tax year, Parent restructured its Country X operations and, as a result of this restructuring, recognized a deemed dividend distribution under I.R.C. § 1248[1/] flowing from Fsub1. This recognition resulted in PTI under I.R.C. § 959 of approximately $aa.[2/].

On Date2, Parent incorporated Sub1 as a State Y corporation. At or around the same date, Parent transferred s% of its stock interest in Fsub1 to Sub1 in exchange for all of Sub1's stock. Parent retained a t% direct interest in Fsub1.

On or about Date3, Sub1 formed Fsub2, a Country X holding company, by contributing ƒaaa to Fsub2 in exchange for r% of Fsub2's stock. Thus, as of Date3, Sub1 owned s% of the stock of Fsub1 and r% of the stock of Fsub2, both Country X corporations.

On Date3, Sub1 sold its s% interest in Fsub1 to Fsub2, receiving cash of $bb, notes of $cc, and additional stock of Fsub2 of $dd for a total purchase price of $ee. The Service does not dispute the purchase price paid by Fsub2 for the Fsub1 stock.

B. Taxpayer's treatment of Sub1's transfer to Fsub2

On Schedule D of the consolidated income tax return for TY1, Parent identified Sub1's transfer of its s% stock interest in Fsub1 as part of the "Region1 Transactions" and treated it as a section 304 transaction. It further characterized the section 304 transaction as consisting of two parts: First, as a deemed capital contribution by Sub1 of the Fsub1 stock to the capital of Fsub2, and second as a deemed redemption by Fsub2 of its stock held by Sub1.

Parent treated the deemed capital contribution as a section 351(a) exchange and included a statement with the consolidated return entering into a gain recognition agreement under section 367, consistent with Temp. Treas. Reg. § 1.367(a)-3T(g) and

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[1/] Section 1248 generally requires a United States shareholder selling or exchanging stock in certain foreign corporations to report a portion of any recognized gain as dividend.

[2/] Section 959(e) generally excludes from the gross income of a United States shareholder amounts which the United States shareholder previously included in income under section 1248. This exclusion occurs at the time the PTI is distributed or deemed distributed.

[redacted]

Notice 87-85.[3/] As a result, it recognized no gain with respect to this part of the transaction.

Because Sub1 constructively owned Fsub1 both before and after the transaction, the taxpayer treated the deemed redemption as a dividend distribution by Fsub2 to the extent of its earnings and profits ("E&P") and then as a dividend distribution by Fsub1 to the extent of its E&P. *See* I.R.C. §§ 304(b)(2)(A) and 304(b)(2)(B).

At the time Sub1 sold the Fsub1 stock to Fsub2 on Date3, Fsub2 had E&P of ƒbbb ($ff) with no PTI, and Fsub1 had E&P of ƒccc ($gg), of which ƒddd was PTI and ƒeee ($hh) was nonPTI. Sub1 had a dollar basis of $aa in the ƒddd of PTI, which had dollar value on Date3 of $ii.

Since Fsub1's accumulated E&P included the $aa of PTI from the YearB fiscal year, the taxpayer excluded it from income under section 959. However, as a result of the receipt of the PTI, the taxpayer recognized and reported an exchange gain of $aaa pursuant to section 986(c)(1). During the audit, Examination and the taxpayer agreed that the amount of Sub1's exchange gain was $jj, which is the difference between the dollar value of the PTI ($ii) on Date3 and Sub1's dollar basis ($aa) in the PTI.

In addition to the exchange gain, the taxpayer recognized and reported a capital gain in the amount of $kk. In arriving at the capital gain of $kk, the taxpayer treated the exchange gain as having been distributed immediately prior to the sale of the Fsub1 stock, thereby increasing Sub1's basis in Fsub1's stock. In a statement attached to the return, the taxpayer acknowledged that if the exchange gain did not increase Sub1's basis, the capital gain recognized would be $bbb, rather than the $kk reported.

The taxpayer treated the $jj of exchange gain under the section 1248 transaction rule, sec. 2(c) of Notice 88-71, 1988-2 C.B. 374, at 380, which treats the distribution of PTI as occurring immediately before the transaction for purposes of computing the exchange gain. As a result, the taxpayer increased Sub1's basis in Fsub1 by the amount of the exchange gain in computing Sub1's basis in Fsub2 stock for purposes of the section 301/304 distribution, as follows:

[3/] Normally, section 367 requires a U.S. taxpayer to recognize gain on certain transfers to a foreign corporation. Thus, Parent and Sub1 by entering into the gain recognition agreement avoided tax on Sub1's deemed capital contribution of Fsub1's stock to Fsub2.

[redacted]

Basis in Fsub1 contributed to Fsub2[4/]	$ll	
Subpart F income (YearC)[5/]		$mm
Subpart F income (YearD)	$nn	
Subtotal	$oo	
Exchange Gain - Section 986(c)	$jj	
Total Basis	$pp	

The taxpayer's calculation of capital gain in the section 304 transaction is as follows:

Cash & Notes proceeds	$ccc
Less:	
Fsub2 dividend	($ff)
Fsub1 PTI	($aa)
Fsub1 dividend	($hh)
Exchange gain (PTI)	($jj)
Subtotal	$qq
Section 301(c)(2) basis recapture	($qq)
Section 301(c)(3) capital gain	$rr

C. Exam's audit of the transfer

On audit, Exam agreed with the taxpayer that the transfer constituted a section 304 transaction to which section 301 applies. Accordingly, it also agreed that in calculating the deemed dividend, the taxpayer properly followed the rules of sections 304(b)(2)(A) and 304(b)(2)(B) by looking first to the E&P of Fsub2, the acquiring corporation, and then to the E&P of Fsub1, the issuing corporation. However, Exam disagreed with the amount of the exchange gain and its impact on Sub1's basis in the section 304 transaction.

[4/] Taxpayer apparently treats Sub1's original basis in Fsub2 as $rr, even though Sub1 initially contributed $aaa to Fsub2 at the time of its organization.

[5/] We assume these amounts constitute subpart F income which increased the basis in Fsub1 stock under section 961(a).

[redacted]

Subsequently, Exam and the taxpayer agreed that the amount of exchange gain should be increased to $jj. However, the parties continued to disagree on the impact of the exchange gain on Sub1's basis for purposes of computing the capital gain on the transaction. In a notice of deficiency issued on Date5, the Service disallowed Sub1's increase in its stock of Fsub1 by the amount of the currency exchange gain for TY1, determining an adjustment to Sub1's capital gain as follows:

Cash & Notes proceeds:	$ccc
Less:	
Fsub2 - Dividend	$ff
Fsub1 - PTI	$aa
Fsub1 - Dividend	$hh
Balance Proceeds	$zz
Less: Sub1's basis in Fsub2	($ddd)
Capital Gain	$ss
Capital Gain-Per Return	($kk)
Adjustment	$tt

LAW AND ANALYSIS

Under I.R.C. § 304(a)(1), if one or more persons are in control of each of two corporations and one of the corporations acquires stock in the other from a controlling person in return for property, then the property paid for the stock is treated as a distribution in redemption of the acquiring corporation's stock. The tax treatment of the redemption is subject to the rules of I.R.C. § 302 to determine whether it is treated as an exchange or as a distribution of property under I.R.C. § 301. To the extent the redemption is treated as a distribution of property subject to I.R.C. § 301, the stock so acquired is treated as having been transferred by the person from whom acquired, and as having been received by the acquiring corporation, as a contribution to the capital of the acquiring corporation.[6/]

[6/] Effective for distributions or acquisitions after June 8, 1997, this provision was amended to provide that in a distribution subject to I.R.C. § 301, the transferor and acquiring corporations are treated as if the transferor had transferred the stock to the acquiring corporation in a transaction to which I.R.C. § 351(a) applies, and then the acquiring corporation had redeemed the stock it was treated as issuing in such
(continued...)

[redacted]

For purposes of I.R.C. § 304, "control" means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote, or at least 50 percent of the total value of shares of all classes of stock. I.R.C. § 304(c)(1). Pursuant to I.R.C. § 304(c)(3), the constructive ownership rules of I.R.C. § 318(a) are applicable, with certain modifications not relevant here, for purposes of determining control.

In a transaction subject to I.R.C. § 304(a), the determination of whether the redemption is treated as an exchange under the rules of I.R.C. § 302(b) is made by reference to the issuing corporation (i.e., the corporation whose stock is transferred). In applying the constructive ownership rules of I.R.C. § 318(a) with respect to I.R.C. § 302(b), sections 318(a)(2)(C) (involving attribution from a corporation) and 318(a)(3)(C) (involving attribution to a corporation) are applied without regard to the 50 percent limitation contained in those provisions. I.R.C. § 304(b)(1).

In the case of a section 304 redemption that is treated as a distribution under I.R.C. § 301, the amount treated as a dividend is determined as if the property were distributed first by the acquiring corporation to the extent of its earnings and profits, and then by the issuing corporation to the extent of its earnings and profits. I.R.C. § 304(b)(2).

In the instant case, Sub1 owned s% of Fsub1 and r% of Fsub2 at the time of the sale of the Fsub1 stock to Fsub2. Accordingly, Sub1 held the requisite 50 percent stock ownership to control (within the meaning section 304(c)) both Fsub1 and Fsub2 for purposes of section 304(a)(1)(A). Thus, Sub1's sale of the Fsub1 stock to Fsub2 in exchange for cash of $bb and notes of $cc constituted a distribution to Sub1 in redemption of Fsub2 stock pursuant to section 304(a)(1). Because Sub1 held s% of Fsub1 both before and after the sale to Fsub2, the redemption fails to qualify as an exchange under section 302(b) and is treated as a distribution subject to section 301.

The exchange of Fsub1 stock for additional Fsub2 stock is not subject to section 304(a) because the Fsub2 stock is not “property,” as defined by I.R.C. § 317(a). However, because Sub1 had control (within the meaning of section 368(c)) of Fsub2 immediately after the transfer of the Fsub1 stock to Fsub2, the transfer of the part of the Fsub1 stock equivalent in value to the Fsub2 stock received in the exchange is treated as a section 351(a) exchange. *See* Rev. Rul. 73-2, 1973-1 C.B. 171; Rev. Rul. 78-422, 1978-2 C.B. 129. As a result, Sub1 did not recognize any gain or loss with respect to the additional Fsub2 stock received in the exchange, and the amount of the payment

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[6](...continued)
transaction.

subject to section 304 (and therefore treated as a distribution under section 301) includes only the amount of the cash and notes worth $ccc ($bb + $cc).

Because the deemed redemption is treated as a distribution subject to section 301, the Fsub1 stock transferred by Sub1 to Fsub2 is treated as a contribution to the capital of Fsub2 pursuant to section 304(a)(1) (prior to the 1997 amendments noted above). Under I.R.C. § 367(c)(2), Sub1's contribution of the Fsub1 stock to the capital of Fsub2 is treated as an exchange of the Fsub1 stock for Fsub2 stock of equal value because Sub1 owned at least 80 percent of the Fsub2 voting stock. In light of Sub1's direct ownership of all of the Fsub2 stock immediately after the transfer, the exchange qualified as a section 351(a) exchange even though there was no actual transfer of Fsub2 stock to Sub1 in the section 304 transaction. *See Lessinger v. Commissioner*, 85 T.C. 894 (1985) (issuance of additional stock to sole shareholder would have been meaningless gesture), *rev'd on other grounds*, 872 F.2d 519 (2d Cir. 1989). Accordingly, taxpayer treated the transfer as a section 351(a) exchange and properly entered into a gain recognition agreement with respect to the deemed section 351(a) exchange under Notice 87-85 and Temp. Treas. Reg. § 1.367(a)-3T(g).

In determining the amount of the section 301 distribution that is treated as a dividend, section 304(b)(2) treats the distribution as if the property were distributed first by the acquiring corporation (i.e., Fsub2) to the extent of its E&P, and then by the issuing corporation (i.e., Fsub1) to the extent of its E&P. As previously noted, Fsub2 had E&P of $ff, and Fsub1 had E&P of $gg on the date of the transfer. Thus, of the $ccc distributed to Sub1 in the section 304 transaction, at least $eee ($ff + $gg) would be treated as a dividend under sections 301(a) and 304(b)(2). However, $aa of Fsub1's E&P was PTI, which would not be taxed again, pursuant to I.R.C. § 959(a).

The amount of the distribution in excess of Fsub2's and Fsub1's E&P is treated as a return of capital that reduces the basis of the acquiring corporation (i.e., Fsub2) under section 301(c)(2), and then as capital gain under section 301(c)(3). In determining Sub1's basis in the stock of Fsub2, the taxpayer treated the $jj of exchange gain under the section 1248 transaction rule, Notice 88-71, sec. 2(c), 1988-2 C.B. 374, at 380. That rule treats the distribution of PTI as occurring immediately before the transaction for purposes of computing the exchange gain. In a section 1248 transaction, the exchange gain is recognized and increases the basis of stock immediately before the transaction. Under section 986(c), foreign currency gain is defined as gain with respect to distributions of PTI attributable to movements in exchange rates between the time of deemed and actual distribution and is treated as ordinary income.

[redacted]

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted]

[redacted] 7/ [redacted]

[redacted]

7/ [redacted]

[redacted]

[redacted] 8/ [redacted] 9/ [redacted]

[redacted] 10/

8/ [redacted]

9/ [redacted]

10/ [redacted]

(continued...)

[redacted]

[redacted]

[redacted]

10/ (...continued)

[redacted]

[redacted]

[redacted]

ISSUE 2. DISTRIBUTION IN TY2 FROM FSUB2 TO SUB1

FACTS

After Sub1's transfer to Fsub2 on Date3, Sub1 retained its r% stock ownership of Fsub2, and Fsub2 owned a s% interest in Fsub1, with Parent owning the other t% interest. On Date4, Fsub1 made a $ggg distribution to Fsub2. Examination has determined that $fff of this distribution was a dividend to Fsub2 and the remaining $ww was a return of capital.

During the subsequent TY2, Fsub2 made distributions to Sub1 totaling $uu. On the consolidated return, the taxpayer did not include the distributions as dividends in Sub1's U.S. taxable income, contending that the distributions were not dividends under section 316 because Fsub2 had no E&P. Because the taxpayer asserts that Sub1 had a basis of approximately $vv in the Fsub2 stock at the time of the distribution, it takes the position that the $uu distribution constituted a return of capital under section 301(c)(2) and was not taxable to Sub1.

Examination and the taxpayer agree that immediately after the transfer of Date3, Fsub2 possessed E&P of $rr. This conclusion apparently reflects the fact that Fsub2 distributed its entire $ff of accumulated E&P as a dividend to Sub1 as part of the section 304 transaction. However, in Examination's view, the $ww treated by the taxpayer as return of capital, as well as the $fff dividend, increased the E&P of Fsub2. Thus, the notice of deficiency issued to Parent on Date5 treated Fsub2 as having sufficient E&P to support the entire $uu distribution to Sub1 as a dividend.

On Date6, Parent commenced a proceeding in Court A , Case#, contesting the entire deficiency asserted with respect to TY2, including the adjustment related to this issue.

LAW AND ANALYSIS

Under I.R.C. § 316(a), the term "dividend" means any distribution of property by a corporation to its shareholders (i) out if its E&P accumulated after February 28, 1913, or (ii) out of its earnings and profits of the taxable year computed without regard to the amount of E&P at the time of the distribution. The E&P of the taxable year is computed as of the close of such year, without diminution by reason of any distributions made during the taxable year. I.R.C. § 316(a); Treas. Reg. § 1.316-1(a)(1). Every distribution by a corporation is deemed to be made out of E&P to the extent thereof, and from the

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most recently accumulated E&P. I.R.C. § 316(a). Under Treas. Reg. § 1.316-2(a), a distribution of E&P is made first out of the E&P of the current taxable year, then out of E&P accumulated after February 28, 1913, and finally out of E&P accumulated before February 28, 1913.

As previously noted, where the distribution exceeds all of the corporation's E&P, section 301(c)(2) treats the excess as a return of capital to the extent of the shareholder's basis under section 301(c)(2), and section 301(c)(3) treats any remaining amount as gain from the sale or exchange of property. In accordance with I.R.C. § 312(f)(2)(A) and Treas. Reg. § 1.312-8, a distribution that is applied against the basis of the stock of the distributing corporation does not increase the E&P of a corporate shareholder, but a gain by the shareholder under section 301(c)(3) increases the shareholder's E&P.

Assuming the $fff of Fsub1's current E&P in TY1 is allocable to the $ggg distribution from Fsub1 to Fsub2, the treatment of the distribution should be as follows. The $fff portion of the distribution (from Fsub1's E&P) would be a dividend to Fsub2 and foreign personal holding company income (subpart F income) to Sub1 taxable under section 951(a). If Fsub2's basis in Fsub1 was $oo (Sub1's carryover basis in Fsub1 stock), the remainder of the distribution ($ww) would be a return of basis to Fsub2 under section 302(c)(2).

<u>CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:</u>

[redacted]

[redacted]

[redacted] 11/ [redacted]

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11/ [redacted]

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Please call if you have any further questions.

By: ______________________________

STEVEN J. HANKIN
Acting Chief, Corporate Branch